No. 82-1653

IN THE
Supreme Court of the United States
OCTOBER TERM, 1983

JAMES MITCHELL NEWMAN,
Petitioner,
v.
UNITED STATES OF AMERICA,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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REPLY TO BRIEF FOR THE UNITED STATES IN OPPOSITION

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REPLY TO BRIEF FOR THE UNITED STATES IN OPPOSITION

The Government's Opposition to the Petition for a Writ of Certiorari demonstrates why certiorari should be granted. The Opposition makes it clear that the Government will view a denial of certiorari here as a mandate to continue prosecuting citizens for both mail fraud and securities fraud on theories that stretch beyond the boundaries intended by Congress and articulated by this Court.

I. THAT SOME LOWER COURTS HAVE REMOVED VIRTUALLY ALL LIMITATIONS ON THE USE OF THE MAIL FRAUD STATUTE TO PROSECUTE COMMON BREACHES OF DUTY ARGUES FOR, NOT AGAINST, REVIEW BY THIS COURT.

The crux of the Government's argument against review of petitioner's mail fraud conviction is that "the courts of appeals have repeatedly upheld the application of the mail fraud statute to breaches of fiduciary duty

like that aided and abetted by petitioner." [1] (Opposition at 8.) While the courts of appeals have hardly been uniform in their treatment of the issue raised by the Petition,[2] it is precisely the liberties taken in many lower court decisions that provide a compelling reason for this Court to review the mail fraud issues presented by petitioner. These cases, which culminated in the Second Cir-

[1] The Government improperly places far too many cases in that category. Respondent provides a long string-cite of cases which purportedly uphold mail fraud convictions like that of petitioner. (Opposition at 8 n.6.) The bulk of these cases involve either the special duties owed to the public by public officials, or kickback arrangements which inevitably result in the diversion of money from an employer or other intended recipient. As noted in our Petition, these factors remove these cases from the category of pure breaches of duty to a private employer with no actual or contemplated pecuniary harm, into which petitioner's case falls. (*See* Petition at 10-11.)

[2] The Fifth Circuit has given the mail fraud statute much more limited breadth than the Second Circuit with regard to the prosecution of breaches of duty of no economic consequence. In *United States v. Ballard*, 663 F.2d 534 (5th Cir. 1981), *reh'g denied*, 680 F.2d 352 (5th Cir. 1982) (per curiam), the Fifth Circuit reversed mail fraud convictions based on alleged breaches of fiduciary duty by employees of oil distribution companies, where the evidence failed to show any economic harm to the companies as a result of the breaches. *Ballard* involved a scheme to pay secret kickbacks from profits generated by the sale of petroleum at a time when oil prices were subject to federal regulation. Because the companies had sold the oil at the maximum price allowable under the federal regulations, the kickbacks received by the employees for causing the oil to be sold to certain purchasers resulted in no economic harm to the employers, and the employees' failure to disclose receipt of the kickbacks was not material. 663 F.2d at 541-42. The court stressed that "[a]ll fiduciary breaches, it seems, could be found to involve the loss of an intangible—an employee's faithful and honest services. But, as the Seventh Circuit has stated, '[n]ot every breach of [every] fiduciary duty works a criminal fraud.'" *Id.* at 540, *quoting United States v. George*, 477 F.2d 508, 512 (7th Cir.), *cert. denied*, 414 U.S. 827 (1973). *See also United States v. Bethea*, 672 F.2d 407, 414 (5th Cir. 1982) (violation of government conflict-of-interest regulation does not constitute mail fraud "absent some detriment to the government").

cuit's decision below, have transformed the mail fraud statute into one of virtually boundless application to common breaches of duty. The decision below is the most radical extension of the scope of the statute to date, since it ignored altogether this Court's historic requirement that there be some actual or potential pecuniary loss to the victim from the alleged mail fraud.[3]

The Government recognizes (Opposition at 7 n.5) that this Court last addressed this issue nearly sixty years ago in *Hammerschmidt v. United States*, 265 U.S. 182 (1924). In that case the Court said that the mail fraud statute was limited to schemes with "the wrongful purpose of injuring one in his property rights" (*id.* at 188) and noted that the statute "should be confined to pecuniary or property injury inflicted by a scheme to use the mails for the purpose." (*Id.* at 188-89.) The Government belittles the significance of this precedent by mischaracterizing the *Hammerschmidt* decision. (Opposition at 7 n.5.) Contrary to the Government's contention, *Hammerschmidt* nowhere suggested that "property injury" might include dishonesty of an employee to his employer which neither results in, nor is responsible for, any economic loss.

The decision below ignored the boundaries articulated in *Hammerschmidt*, as have other courts with increasing

[3] Contrary to the Government's implication (Opposition at 7), petitioner does not contend that a mail fraud conviction requires proof of *actual* economic harm or injury to the victim, but recognizes that contemplated economic injury also falls within the statute's proscription. (*See* Petition at 8-9.) Petitioner's conviction, however, was based on a jury instruction that contained no requirement of actual or contemplated pecuniary injury:

> "[I]t is not necessary in a mail fraud case based upon a breach of fiduciary duty by a private employee for the government to prove direct, tangible, economic loss to the victim, actual *or contemplated*. The object of a fraudulent scheme need not be the deprivation of a tangible interest, such as money, from another. Schemes designed to deprive [their] victims of intangible rights also violate the mail fraud statute." (App. at 123a, emphasis added.)

extremism over the past several years. The issue warrants revisitation by this Court.

II. THE GOVERNMENT'S VIEW THAT *DIRKS v. S.E.C.* IMPLICITLY DECIDES THE MISAPPROPRIATION ISSUE LEFT OPEN IN *CHIARELLA v. UNITED STATES* MAKES REVIEW OF THAT ISSUE IN THIS CASE ESSENTIAL.

The securities fraud issue presented by the Petition is straightforward.[4] Neither petitioner nor his colleagues had or breached any duty cognizable under the securities laws to those from whom petitioner bought securities. The sellers all were, and remain, strangers to the purchasers. Moreover, neither petitioner nor his colleagues misappropriated any information from any entity or person who owed a duty of disclosure or abstention to the sellers of those securities. The Government's theory is that they misappropriated information from their employers. But the employers and their clients had no duty to those sellers either. They undoubtedly could have law-

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[4] The Government suggests that review of petitioner's securities fraud conviction is unnecessary because his sentence on that conviction is concurrent with his sentence on the mail fraud counts. (Opposition at 9.) However, petitioner's conspiracy conviction, for which he was fined in addition to receiving a concurrent prison sentence, depends on the securities fraud issue as well. The Government's contention (Opposition at 9 n. 7) that the conspiracy conviction would stand even if the securities fraud conviction were reversed is wrong. In *Yates v. United States*, 354 U.S. 298, 312 (1957), this Court held that where a single conspiracy to commit separate offenses is charged, "the proper rule to be applied is that which requires a verdict to be set aside in cases where the verdict is supportable on one ground, but not on another, and it is impossible to tell which ground the jury selected." Here, the district court specifically charged the jury that it could find petitioner guilty of conspiracy if it found that he had participated in a conspiracy to commit *either* mail fraud *or* securities fraud and that it need not find a conspiracy to commit both offenses. (App. at 102a-103a.) Because the jury's verdict may have rested solely on a finding that petitioner conspired to commit securities fraud, reversal of the conspiracy conviction would be required if the securities fraud conviction were reversed.

fully purchased the same securities from the same persons without disclosing the impending tender offers. The question presented, then, is whether, because of an earlier "misappropriation" of information by his colleagues from their employers, petitioner can be prosecuted for fraud in a securities transaction in which no party was owed a special duty of disclosure or was affirmatively misled.

Petitioner believes the misconduct charged here—breach of an employee's duty of honesty to an employer not engaged in related securities transactions—is simply not the type of conduct addressed by Section 10(b) of the Securities Exchange Act of 1934 or Rule 10b-5 thereunder.[5] The Government has not alleged that petitioner owed any duty of disclosure to other parties to the securities transactions in which he engaged. (*See* App. at 59a-61a.) The jury was not charged with assessing whether petitioner defrauded "the persons from whom [he] purchased stocks." (*See* Petition at 14 n.17.) Indeed, the Second Circuit specifically held that petitioner could be convicted even though none of the parties the Government had alleged he defrauded was a purchaser or seller of securities in any transaction with petitioner. (App. 44a.) The only persons allegedly defrauded were the employers of petitioner's colleagues, and their clients, neither of whom engaged in any securities transactions with him. In this context, petitioner's purchase of securities is significant only as a jurisdictional device to apply Section 10(b) to the alleged breach by employees of the duty of honest service to their employers. This is an expansion of the concept of fraud "in connection with the purchase or sale

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[5] *Cf.* Recent Developments, *Securities Regulation—Retributive or Remedial: What is the Objective of Imposing Criminal Sanctions in Section 10(b) Actions Under the 1934 Securities Exchange Act?* 8 J. CORP. L. 527, 528 (1983) ("[The *Newman*] decision is significant because many activities, which otherwise would have gone unpunished due to a lack of duty between the buyer and seller, will now be punishable under section 10(b) and rule 10b-5").

of securities" far beyond any application this Court has allowed.

The Government's theory in this case, and the grounds for the decision of the court below, are in direct conflict with several of this Court's recent decisions. In *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977), this Court held that Section 10(b) could not be substituted for a longstanding statutory framework under state law governing the duties claimed to have been breached, even if those breaches arose in the context of a securities transaction. (*See* Petition at 15-17.) The Government addresses this issue only by asserting that *Santa Fe* "does not give courts a license to decide that certain conduct, although covered by the express terms of Section 10(b) and Rule 10b-5, is better left to state regulation." (Opposition at 12.) Obviously, this response begs the key question presented in *Santa Fe*: Whether a breach of duty under state law ancillary to (or, as here, almost unrelated to) a securities transaction is "covered by the express terms of Section 10(b) and Rule 10b-5." Petitioner believes that an employee's "misappropriation" of information from his employer does not fall within the antifraud provisions of the securities laws.

The conflict with this Court's decision in *Chiarella v. United States*, 445 U.S. 222 (1980), is even more manifest. In *Chiarella*, this Court held that Section 10(b) created no duty to the market at large to disclose nonpublic material information or refrain from trading in affected securities. The "duty" analysis in *Chiarella* has been virtually ignored in petitioner's case.

The Court reaffirmed the duty analysis of *Chiarella* in its recent decision in *Dirks v. S.E.C.*, No. 82-276 (July 1, 1983). *Dirks*, like *Chiarella*, emphasized that any securities law duty that might prohibit trading without disclosure of material nonpublic information arises from the relationship between the purchaser and seller of securities. The *Dirks* Court reiterated that "there is no general

duty to disclose before trading on material nonpublic information" (slip op. at 6), and that any such duty as does exist must arise from a special relationship between the parties to the transaction (*id.* at 7, 10).[6]

Instead of coming to grips with the inconsistency between its position and the duty analysis of *Chiarella* and *Dirks*, the Government claims that in *Dirks* the Court "*implicitly* recognized that liability could be imposed for 'misappropriat[ing] * * * information,' (slip op. 18)." (Opposition at 10, emphasis added.) This assertion misconstrues *Dirks*. At most, the Court's reference to "misappropriation" in *Dirks* was to make it clear that the "misappropriation" issue left undecided in *Chiarella*, 445 U.S. at 236, was not presented or decided in *Dirks* either. The Government's Opposition leaves no doubt that if certiorari is denied the Government will continue to bring prosecutions on the "misappropriation" theory, claiming support not merely from its suggestions of "implicit recognition" of the validity of this theory in *Dirks*, but also from the very decision petitioner here seeks to have reviewed.[7] This Court should not countenance such a patent misuse of its earlier opinion.

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[6] *See, e.g.*, Pitt & Ain, *"Dirks" Deals Blow to SEC Insider Trading Program*, Legal Times (July 11, 1983) at 10, 15:

> "On balance . . . the *Dirks* decision tends to vitiate, rather than to confirm, the 'misappropriation' theory. After all, *Dirks* makes clear that, in order for a person who trades on the basis of confidential nonpublic corporate information to be held liable under Rule 10b-5, where that person does not affirmatively misstate any facts or induce any trading transactions, the trader must be under a duty to disclose, as embodied in 'a specific relationship between the shareholders and the individual trading on inside information' . . . ."

[7] In fact, the S.E.C. has begun to take this position generally in Rule 10b-5 litigation. In its post-trial brief in *S.E.C. v. Lund*, Civ. Action No. 81-0371 MML(Kx) (C.D.Cal.), the S.E.C. wrote that: "In *Dirks* . . . the court inferentially supported the misappropriation theory in its opinion. *Dirks v. S.E.C.*, slip op. at 18. The misappropriation theory has been adopted by the Court of Appeals for the Second Circuit in *United States v. Newman* . . . . It is significant that no Justice of the Supreme Court has expressed disagreement with the misappropriation theory." (*Id.* at 7-8.)

Finally, the Government's Opposition fails to recognize the implications to the broader securities marketplace of the decision below. As the Court noted in *Dirks*, the whole securities marketplace will suffer unless market professionals and analysts "have some guidance as to where the line is between permissible and impermissible disclosures and uses . . . ." (Slip op. at 11 n.17.) The Government attempts to minimize the uncertainty created by competing views of the applicability and breadth of the "misappropriation" theory of Section 10(b) liability. (Opposition at 12-13.) The truth is otherwise. Absent clarification by the Court, a cautious market professional concerned for any reason that information he has obtained may have come from unauthorized disclosures will have to abstain from trading on, or disseminating, that information. This is because even if no duty of disclosure otherwise arises under the standards set forth in *Dirks*, the Government's misappropriation theory could still support a fraud prosecution.

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For all the reasons set forth herein and in our Petition, this Court should grant the requested Writ of Certiorari.

Respectfully submitted,

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